CHCF could rise dramatically. In addition, the CHCF may be discontinued upon completion of the small LECs' general rate cases ordered in D.94-09-065.

We do not find AirTouch's comment that we are not authorized to institute new universal service rules as a result of AB 3643 compelling. Such an argument overlooks the fact that other legislation, specifically AB 3606 (1994 Statutes, Chapter 1260), added PU Code § 709.5 to state that all telecommunications markets be opened to competition no later than January 1, 1997, and that the Commission take the necessary steps to put into place "whatever additional rules and regulations that may be necessary...." (PU Code § 709.5(c).)

C. The Mechanism for Funding High Cost Areas

1. Proposals for Funding High Cost Areas

a. Introduction

In deciding how high cost areas will be funded in a competitive environment, several issues are raised.

The first issue that needs to be addressed is whether the mechanism for funding a high cost area should only be for residential customers. The CHCF currently focuses on subsidies for the smaller LECs, and does not make a distinction as to whether the subsidy is for the smaller LECs' residential or business customers.

The second issue, which is not limited just to high cost areas, is which provider undertakes the franchise obligation of being the carrier of last resort (COLR) for a particular area.

The COLR is the regulatory concept that there must always be a provider that is obligated to serve all customers in a particular service area. The 22 LECs have been the COLR in California's 500 plus local exchanges. With the introduction of competition, the COLR concept changes because certain competitors may choose to serve a smaller service area or group of customers than the incumbent LEC is now obligated to serve. In certain areas, within existing LEC service territories, that may result in more than one COLR, and in other areas there may only be one COLR.

In order to gain insight on why changes to the existing CHCF are necessary, a brief description of the CHCF is in order. Traditionally, the funding for high cost areas has come from pooling of local exchange carrier revenues. When switched access rates were reduced in 1985, a large reduction in access pool revenues resulted. This led to the creation of the present mechanism, the CHCF. (See D.85-06-115 (18 CPUC2d 133).) The CHCF was established so that drastic increases in the smaller LECs' local exchange rates could be avoided. Because the reduction in switched access rates and access pool revenues was not due to any decrease in LECs' costs, the smaller LECs' revenue requirements had to be subsidized if their basic exchange rates were to remain reasonable. The CHCF subsidizes reasonable basic exchange rates for customers of the smaller LECs that concur in statewide average toll, private line, and access rates. Pacific and GTEC fund their high cost exchanges with internal cross subsidies, and revenues from directory advertising.

The Commission, in anticipation of having to change the funding mechanism for high cost areas, requested in the universal service OIR/OII that parties comment on two particular methods of funding high cost areas, the voucher method, and the auction method. Both methods are beneficial from the standpoint that the subsidy for funding high cost areas is directly identified, and each method allows multiple competitors in the local exchange market.

In brief, the two methods are as follows. The voucher system for high cost areas would work by giving the customer a credit voucher for a set amount of money which represents the difference between the actual cost of serving a customer and a rate that is deemed affordable by the Commission. The cost of serving the customer would be determined through cost studies. A variation of the voucher is the virtual voucher. With a virtual voucher, the customer chooses a provider. The carrier that the customer selects would then draw a subsidy from the fund on behalf of the customer, and would credit that customer's bill with the amount of the subsidy. The customer then pays the balance of the bill. From the customer's perspective, a virtual voucher is easier to administer than a voucher.

The auction or bidding mechanism would allow qualified providers to bid a fixed amount of basic service subsidy necessary to serve a high cost area. The bidder with the lowest bid would become the subsidized COLR for that area for a set period of time.

b. Positions of the Parties

Several parties commented in favor of the virtual voucher proposal. One of the biggest proponents of the voucher is the Coalition. The Coalition thinks that the voucher method provides significant advantages over an auction approach. The Coalition states that under the voucher method, the customer doesn't have to do anything except to choose a provider, and pay a monthly bill, some of which will be subsidized. In addition, the voucher method is easier to administer.

The Coalition believes that the auction approach would give an advantage to the incumbent LECs because a carrier would be required to be ready to serve an entire area as a COLR. Under the voucher method, carriers could come into the market when they are prepared to do so. Instead of serving an entire area, under the voucher method, the carrier could select the area that it wants to serve. The Coalition also claims that GTEC's bidding mechanism proposal relies on LEC resale. The Coalition fears that winning bidders will be faced with price squeezes or lack of unbundling which will preclude competition from developing. The Coalition states that the incumbent LEC should retain the COLR obligation until procedures are in place to select another COLR.

Thus, for a period of time between the authorization of competition and the implementation of a new funding mechanism for high cost areas, the incumbent LECs would continue to have the obligation to serve.

The Coalition recommends the auction method as a supplemental COLR mechanism in the event no provider is willing to come forward and assume the COLR responsibility. Such a mechanism would serve as a safety net to ensure the availability of basic exchange service. The Commission or any provider could initiate an auction whereby service providers would bid to be the COLR for the area. The bid could be in the form of a lump-sum amount, over and above the per line subsidy that would be provided for that particular area, which the bidder would receive for committing to be the COLR in the geographic area. The service provider requiring the smallest subsidy would become the COLR for a specified number of years, with competitive entry allowed. If the winning bidder were not the incumbent LEC, then the LEC would be required to offer its facilities for that geographic area to the winning bidder at the net book value of the facilities.

Citizens favors a voucher approach as well. However, Citizens believes that prior to instituting a voucher system, the first step is to allow the rates of the LECs to move upwards toward their actual cost. Once rates move toward cost, the Commission could determine the level of subsidy that would be appropriate for providers in qualifying high cost areas. Contribution credits could then be attributed to the LEC or any other provider that offers service in a high cost area.

Citizens says that the virtual voucher would be relatively easy for customers to understand and use, but some education would be necessary beforehand. The provider would find the systems relatively simple to administer because the net contribution credits would be allocated to it by an independent fund administrator. The provider would have to establish a billing system that reflects the contribution credits and bill only the difference between the market price and the subsidy amount to eligible targeted customers. If the fund were administered by an independent trust, all the Commission would have to do is to monitor the system and reexamine the level of the subsidy as needed.

Citizens believes that the voucher system will encourage competition and the entry of additional providers because the disbursements are available for qualifying high cost areas to any carriers willing to provide services to those areas. As rates move toward cost, Citizens expects that all areas will become more attractive to competitors.

Citizens suggests that under a virtual voucher mechanism, the designation of a COLR is a moot issue because there will be funding for high cost areas, and the eligible customer can choose from multiple providers. Citizens says that in a market of multiple providers of service, all providers should serve all customers requesting service. Citizens says that a COLR designation needs to be made in only two instances: (1) when no carrier has entered the market and the incumbent must continue to serve all potential customers; and (2) when, after competitors have entered the market, all but one decide to exit, the remaining carrier must be designated as the COLR. If all the carriers decide to exit an area, the Commission could then hold an auction to select the carrier willing to serve with the lowest level of high cost support.

Pacific and GTEC favor the bidding mechanism proposal that GTEC submitted in connection with the FCC proceeding on universal service. The GTEC bidding mechanism would support carriers who plan to undertake a COLR obligation. Their method would initially be based on the LEC's incremental costs, using a proxy cost approach to estimate the cost for each newly defined market area. The proxy cost study would then be trued-up, if necessary, to recover the full LEC book costs. This cost based approach would be replaced by a competitive bidding process when new firms are willing to enter a geographic area to be carriers of last resort in a given geographic area. This auction or bidding process would result in an amount, determined by the lowest bid of a qualified firm. That amount represents the support required by the winning bidder to serve that area. The winning bidder would then be committed to serve as the COLR in the given area. Any other qualified carrier would then be allowed to opt-in or opt-out of being a COLR in that area at the support level determined by the lowest bid amount for the defined package of local service. COLRs would disclose to all consumers that they stand ready to serve any customer within their market area. The proposal favored by GTEC would allow multiple firms to assume COLR obligations, while allowing replacement of an incumbent LEC as the COLR.

GTEC contends that the bidding process will provide an objective means for determining when the auction mechanism is no longer needed to assure supply at affordable rates in a given area. When the submission of subsidy bids converges to zero, this will indicate that the Commission's required rate is close to the market rate where firms will provide service without support.

Pacific believes that a voucher system would require customers to be highly knowledgeable about their choices and how to compare them. In addition, Pacific contends that the voucher and virtual voucher mechanisms would require significant regulatory overview to determine appropriate presubscriber subsidy levels in a way which is objective and competitively neutral. It would also require that a system be set up to carry out the voucher transfer between the customer and the company.

For the auction method, Pacific proposes that funding for each high cost area be determined at the wire center level. Pacific claims that ignoring customer differences will result in cream skimming, i.e., the competitors will target the more profitable high volume business and residential users. Pacific states that the Commission should supervise the bidding process, and that the actual auction process should be delegated to a third party with the costs borne by the bidding parties.

Pacific believes that there could be multiple COLRs. If that were the case, the Commission would have to ascertain and monitor the financial integrity of more firms than if only one COLR was in place. Pacific believes that multiple COLRS could also lead to gaming, by referring unattractive customers, i.e., high cost or low revenue customers, to other COLRs. Also, multiple COLRs raise the issue of whether this would lead to efficient infrastructure investment because a fixed amount of subsidy would be spread between two infrastructures. One way of overcoming this problem is through resale of another carrier's services.

Even though Pacific favors an auction mechanism, Pacific argues that other regulatory changes and attitudes need to change in order to sustain universal service. In particular, Pacific contends that the NRF sharing and price indexing mechanisms need to be eliminated. In addition, Pacific believes that LECs should be encouraged to enter new markets by eliminating rules which restrain LECs from investing.

Pacific believes that after further regulatory reform, the only service that will require subsidy support will be residential basic exchange service. Pacific believes that all other services should be priced at or above their costs on a geographically deaveraged basis. If any business rates remain geographically averaged, then subsidy fundings of these businesses in high cost areas would also be required.

Pacific believes that the Commission needs to evaluate the circumstances of the small LECs independently, and design appropriate plans for their service territories. Although the goal of universal service is to provide uniform service at affordable rates statewide, Pacific states that the regulatory schemes need not be uniform among all the California exchanges.

McCaw also supports a bidding process to select the COLR for high cost areas.

Although the Smaller Independent LECs do not believe that the current CHCF should be changed, they did comment on the voucher and auction methods. They believe that the voucher system would be difficult and costly to administer. The cost of administration would have to be recovered through additional charges on carriers or end users. The Smaller Independent LECs also contend that the voucher system does not address incentives for infrastructure development in rural areas. With respect to the auction method, they state that auctions may be a feasible alternative for bidding for previously unserved territories, but it would not be suited for territories already being served. They argue that an auction mechanism raises serious legal issues regarding a regulatory taking and just compensation.

Roseville does not believe that the auction process promotes the goal of providing high quality universal telephone service. Roseville contends that the auction process provides little incentive to encourage long run infrastructure development. In addition, the auction process does not eliminate the need to provide recovery for the embedded costs of plant put in place to meet the COLR obligations.

Roseville suggests that in order to ensure the maintenance of universal service, there is a need to designate a facilities-based COLR for all telephone subscribers in each geographic area. Roseville recommends that the existing LEC be designated as the COLR for basic exchange services in their territories. Allowing the incumbent LEC to remain in place as the COLR acts as a safeguard to ensure that service continues in that particular area and minimizes service disruptions. For those customers who don't want an alternate provider, they retain the existing LEC to which the customer is accustomed.

CCAC proposes that the Commission should consider whether the COLR obligation should be borne by providers other than the LEC. With the growing use of wireless telecommunications, a wireless provider might be able to assume the COLR obligation in a more limited geographical area at a lower cost. CCAC also suggests that resale be allowed to avoid duplication of facilities.

DRA does not believe that either a voucher system or an auction is necessary at this time. Instead, DRA proposes a two-stage transitional period before full local exchange competition is reached. In the first transitional period, basic services would be recategorized from Category I to Category II.[14] LECs would maintain their existing rates for basic services, and CLCs would have pricing flexibility for their basic services. The transition to the second stage would occur if the following conditions are met: (1) the LECs are authorized to enter the interLATA markets; (2) cost study requirements per D.94-09-065 are met; and (3) equal access is authorized and implemented for all carriers. During this period LECs would be authorized to establish a cost based rate for basic services based on the cost studies performed in response to D.94-09-065. Upon a finding that effective competition exists, then full competition would be allowed. At that time, all LECs and CLCs would have full pricing flexibility for basic universal service, and the LEC's basic services would be recategorized to Category III, above the line services.

Under DRA's proposal, no additional funding for universal service other than the existing ULTS program, the Deaf

14 The three categories of service are described in D.89-10-031. (33 CPUC2d at pp. 125-126.)

and Disabled Telecommunications Program, and the CHCF, would be needed. In the future, when the market is found by the Commission to be effectively competitive, then DRA proposes an auction for the ULTS program. DRA states, however, that this will not happen for a while and need not be addressed at this point. With respect to possible changes to the CHCF, DRA says that this issue should be revisited when the smaller LECs file their general rate cases and/or elect to be regulated under the new regulatory framework structure.

c. **Discussion**

In the redesign of both the CHCF and the ULTS program, the Commission must fashion mechanisms which ensure competitive neutrality, and at the same time ensure that the benefits of competition can be realized without affecting the goals of affordable and ubiquitously available service.

Both the auction method and the voucher method require the development of extensive administrative procedures. Both programs also require periodic review either to conduct the auctions, or to review costs to determine if the subsidy for funding high cost areas should be reduced.

Our proposed rules do not put recommend an auction as the primary mechanism for distributing high cost subsidies. The reason for this is that auction proposals would appear to result in one of two outcomes: (1) there are multiple winners so bidders have little incentive to bid down the subsidy or (2) there is a single winner and subsequently little consumer choice. Under GTEC's multiple winner proposal there does not appear to be any incentive for bidders to bid down the subsidy required to serve a particular area. By failing to generate low bids, the required subsidies for high cost areas are likely to remain high rather than be reduced over time. If, in contrast to GTEC's proposal, we were to adopt an auction which identified a clear winner with exclusive access to subsidy funds, then we may be forcing customers to take service from a particular carrier, the one who wins the auction. By reducing consumer choice, this may conflict with our objective of bringing the benefits of competition to all Californians.

In addition, we believe that auctions for all high cost areas would be administratively difficult. The Commission or its designee may have to become involved with numerous, ongoing auctions.

While we are not proposing an auction as the primary mechanism for distributing high cost subsidies, we recognize some of the potential advantages of an auction. First, auctions rely less on controversial cost studies than the voucher system. Even though cost studies may be used to establish a basis or benchmark in an auction system, the bidding process should correct any errors carriers detect in cost studies. Second, an auction encourages bidders to focus on the overall business opportunity of high cost areas, rather than narrowly on the cost of basic services. If bidders view a subsidy as a means of gaining access to profitable toll or other ancillary markets, they may be willing to bid low. By contrast, a voucher system does not allow for viewing basic service as access to more lucrative markets.

Parties that advocate an auction as the primary mechanism for distributing subsidies for high cost areas should file comments regarding the following: (1) what incentives are there to bid low; (2) how consumer choice would be accommodated with an auction; and (3) is the auction mechanism administratively feasible.

DRA's phased approach has some merit in that no significant alterations are required to the existing universal service programs. Instead, DRA's proposal relies on competitive forces to ensure that basic service remains affordable and ubiquitously available. One drawback to DRA's approach is that no proactive steps are taken to determine the subsidies in high cost areas and for low income customers, and to develop a plan to reduce those subsidy amounts.

We agree with DRA's general premise that any new explicit subsidy for large LECs should only be implemented when (1) there is reliable evidence based on sound cost studies that a subsidy is necessary and (2) the minimum conditions for competition, such as unbundled network components, interconnection arrangements, intraLATA presubscription and interLATA relief, are in place. However, we feel it is important to have a mechanism ready to put in place when full competition occurs.

We have considered the comments of the parties regarding the various kinds of funding mechanisms that can be utilized to further promote the universal availability of telecommunications services in a competitive environment. We have also compared the CHCF to the different proposals. We propose that the current CHCF be replaced with a virtual voucher system of funding, which we shall refer to as the high cost voucher fund. We also propose that an auction mechanism be used as a safety net in the event no single carrier is willing to undertake the COLR obligation. With a properly constructed funding mechanism for ensuring universal access, the combination of a high cost voucher fund and the backup auction mechanism will guarantee that no service territory is at risk of losing telephone service.

The purpose of the high cost voucher fund is to provide subsidies in high cost areas of the state. This fund differs from the CHCF in that all areas of the state with high cost areas can be subsidized. In addition, this fund will allow all providers in high cost areas to draw from the fund, while allowing the customer to select among a choice of providers. The high cost voucher fund also differs from the CHCF because under our proposal, the smaller LECs will no longer be funded so as to meet their revenue requirements.

We propose that the high cost voucher fund be available to all carriers of residential basic service. This is a departure from the current CHCF which provides funding for the overall company costs of the small and medium sized LECs. Our proposed redesign of the high cost fund will subsidize high cost residential customers explicitly, rather than adhere to the current system of implicitly funding both business and residential customers. To the extent that high cost LECs have recovered their costs through the CHCF, rather than through higher business rates, the high cost LECs may need to raise business rates to recover their costs of serving the business community.

In the event there are no carriers willing to undertake the COLR obligation, we propose that an auction method be used. This auction mechanism would be used in a situation where no provider is willing to assume the COLR obligation unless that carrier is guaranteed an additional payment. If no party is willing to come forward and assume the COLR responsibility at the predetermined subsidy level, then the Commission or any qualified provider can propose to initiate an auction whereby service providers can bid to take over the COLR obligation, for an amount, over and above the established per line subsidy that would be provided for each geographic area.

In order to implement this high cost voucher fund mechanism, several other details need to be addressed. The first is to determine how much it costs to serve particular areas of the state. In order to accomplish that, the areas of study need to be defined, and cost studies need to be submitted. Once the costs are known, the second detail is to determine which areas of the state are high cost areas that the fund should subsidize. Once that is known, then the total subsidy for the high cost areas can be determined. The third detail is determining who the COLR should be, and whether criteria need to be developed as to which carrier is qualified to be a designated COLR. The fourth detail is to set up a mechanism to collect the subsidy. Inherent in this fourth detail is determining who should be responsible for the surcharge. These issues are described below.

2. Cost Studies to Determine the Subsidy Amount

a. Introduction

The commenting parties, whether they favor a voucher approach or an auction approach, appear to be in agreement that before either method is adopted, some sort of cost studies are necessary. Before a voucher system is instituted, the parties in favor of such a mechanism assert that the amount of the subsidy needs to be determined. Under GTEC's proposal, the incumbent LEC would continue as the COLR until an auction is held. During that initial startup, GTEC proposes that COLR funding be based on a cost based approach.

We recognize that cost studies are likely to be contentious, and that cost studies may vary somewhat from actual costs. However, requiring cost studies is a good starting point for determining whether a subsidy is needed, how large the subsidy needs to be, and how the subsidy should be targeted. The cost studies are a useful tool for analyzing where rates should be in comparison to costs. Without cost studies, we would have to rely on the outcome of the auctions to determine how large the subsidies should be.

The methodology for these cost studies is nearly as contentious as the mechanism in which they are used. One idea is to base cost studies on recorded costs. The small and medium size LECs favor this approach. They assert that actual costs can be easily determined because their service areas are so small.

Another idea as to how costs are derived is based on using proxy factors to estimate the costs of certain areas. Under the proxy factor method, the Commission would examine a sample of actual costs from areas of different population density and terrain around the state. From this sample, proxy factors could be developed which estimate the loop cost based on loop length, population density and possibly terrain. The Commission would then apply these proxy factors to areas of the state where actual costs have not been used.

As we understand it, actual cost information is developed for the FCC on a study area basis. For most of the LECs in California, this typically means all of the LEC's territory within the state. Thus, the accounting data for costs is generally representative of a wide area. The problem with using such a large study area in the design of a funding mechanism for high cost areas of a state, is that the cost of serving customers is likely to vary dramatically from one part of the study area to another. Typical reasons for such variance are because of density, terrain, and environmental conditions. As a result of such variances, high cost areas within a study area are averaged together with the low cost areas within the study area.

Under the current system of implicit subsidies, low cost areas help to subsidize high cost areas.[15] Such a system works in a monopoly environment. However, with the introduction of competitive forces, this system is no longer viable.

b. Geographic Study Areas

In order to design a funding mechanism which targets California's high cost areas, study areas that are smaller than the single statewide study area are needed. We shall refer to these smaller study areas as geographic study areas (GSAs). The GSAs will serve as reference points from which cost data can be derived, and from which the subsidies for the designated COLR or COLRs can be derived. (See proposed Rule 6.A., App. A.) We also propose that the designated COLR be required to serve areas based on GSAs.

15 Implicit subsidies also occur between services, exchanges, and among high and low revenue customers.

Such a requirement will allow the funding mechanism to easily match up the designated COLR with the subsidy amount to which the COLR is entitled to. (See proposed Rule 6.D.5., App. A.)

In determining the size of a GSA, a small region avoids cost averaging between customers, and prevents barriers to entry. Smaller GSAs should also be better able to determine the total amount of subsidy required statewide. We tentatively conclude that census block groups should serve as the GSAs. (See proposed Rule 6.A.2., App. A.) Census block groups have the advantage of being compact enough that the cost to serve residential customers within them should be relatively homogeneous. Our selection of this compact geographical area seeks to avoid the cost averaging disparity between the cost of serving a town center and the less dense outskirts of town. The census block groups also have readily available demographic data such as population density.

We recognize that there are some disadvantages with the census block group approach as well. For instance, there are a lot of census block groups, and the census block group is not a unit by which telephone data is traditionally kept. However, if costs are going to be developed on a proxy basis, the only disadvantage is that the calculations for all the different GSAs will take some time.

We are also open to other alternative sized GSAs such as the LEC wire centers, zip codes or larger census bureau designations. Although larger geographic units may be easier to administer, they are likely to mask differences in the cost of service because of cost averaging. In addition, a large GSA may act as a barrier to entry if each COLR receiving a subsidy is required to serve on a GSA basis.

We welcome comment on whether census block groups can be used effectively as GSAs to develop costs and the total subsidy amount. If an alternate type of GSA is recommended, please comment on how that geographic unit can accomplish the following:

(1) promote the ease of administration; (2) provide access to demographic and other data; (3) provide access to telephone cost data; and (4) whether the size of the GSA will act as a barrier to those providers who want to become a designated COLR or who want to offer services in that GSA.

c. Formulation of the Cost Studies

The next step is to decide how the costs should be developed for the GSAs. Except for the small and medium sized LECs, it appears that cost data has typically been for the statewide study areas of Pacific or GTEC.

GTEC contends that because there is limited data on actual costs below the statewide study area level, a proxy approach should be used to develop incremental cost estimates. GTEC believes that a proxy approach provides a means of capturing the differences in costs across small geographic areas through the use of variables. However, GTEC says that proxy costs are still imperfect and need to be reconciled with actual cost data at the statewide study area level. According to GTEC, actual costs include the markup over incremental cost needed to recover the joint and common cost of the firm.

Pacific favors a proxy method using wire centers as the GSAs. The costs for each of the wire centers in the state would be based on cost templates of six to eight kinds of typical wire centers.[16] Pacific states that the proxy cost could then be adjusted, if necessary, to take into account the special circumstances of particular wire centers, such as unusual terrain, climate characteristics, or atypical levels of service.

16 Pacific's proxy formula would estimate cost as a function of certain observable variables. The primary variables are population density by itself or together with loop length.

The Coalition says that the cost studies may serve as the basis for calculation of a universal service subsidy if they are conducted according to the following principles: (1) the cost studies must identify the TSLRIC of local exchange service; and (2) the costs of basic service must be determined for different cost areas or cost zones, defined strictly with respect to the cost characteristics of geographic areas.

We propose that costs for all the GSAs be developed by way of proxies. For the small and medium sized LECs, if actual cost data is available, that information should be used in determining the high cost GSAs. If the small and medium sized LECs do not have any verifiable cost data, then the cost studies should be done by way of proxies. (See proposed Rule 6.A.5., App. A.)

We request comment on the following: (1) can cost proxies be developed for different types of cost categories, and if so, how many categories would be needed; (2) can the GSAs be categorized into the different types of cost categories; (3) how should the proxy formulas be developed, and are workshops or hearings necessary to develop these formulas;[17] and (4) can the relative accuracy of the proxies be verified by comparing them to actual costs incurred by the small, medium, and large LECs?

17 The need for subsidies in high cost areas depends on the revenue generated by consumers in those areas. At a minimum revenue consists of the rate charged for flat rate or measured rate residential service and the End User Common Line (EUCL) charge. However, other revenues may need to be considered. For example, PU Code § 728.2 directs the Commission to consider the net commercial directory revenues for the purpose of establishing rates for other services. In addition, a portion of the interstate per line cost is currently recovered through the carrier common line charge. We invite comment as to what revenues beyond the tariffed rate and EUCL should be considered in determining the appropriate per line subsidy for high cost areas at the outset of competition.

We propose that the cost studies for determining the existence and amount of cross subsidies supporting rates for basic services that are below cost be handled in the ongoing OANAD OIR/OII. We believe that concentration of cost issues in a single proceeding will result in the most efficient use of Commission and party resources. We recognize that this adds a new dimension to the OANAD cost process. However, the OANAD proceeding is examining the costs associated with unbundling basic network functions. Basic service is intimately associated with those network functions, and some of the work product for determining basic network functions may overlap with what is needed for the cost studies of high cost areas. Upon the completion of the cost studies relating to high cost areas in the OANAD proceeding, the total subsidy for high cost areas can then be derived and used in this proceeding to put the high cost voucher fund into effect.

Due to the proposed schedule in the OANAD proceeding (see Assigned Commissioner's Ruling in OANAD, June 22, 1995), a decision as to whether the cost studies for high cost areas should be handled in the OANAD proceeding needs to be resolved quickly. We may issue an interim decision shortly after the initial round of comments are filed in this proceeding if we decide that the cost studies for high cost areas should be done in the OANAD proceeding. We request comment on whether the cost studies for high cost areas should be done in the OANAD proceeding. Commenting parties should explain: (1) whether such a procedure is appropriate given the focus of each proceeding and the resources needed for cost studies; (2) whether the cost studies in connection with high cost areas are likely to overlap with the cost issues associated with unbundling; and (3) whether the cost studies for high cost areas can be completed within the proposed OANAD schedule for cost studies.

d. Determining High Cost GSAs

The next problem to address in designing the high cost voucher fund mechanism is to decide how high cost GSAs should be determined. That is, the Commission needs to establish a reference or benchmark as a point of comparison. In theory, if the costs in a GSA exceed this reference or benchmark price, the GSA would be considered a high cost GSA and would receive funding from the high cost voucher fund.

GTEC advocates that the Commission determine the initial benchmark price that a customer is willing to pay for a defined basic service package. The benchmark price would be the total monthly price which includes all rate elements of that service. The Coalition suggests that the net subsidy amount available should be based on the differential between the TSLRIC of basic service and the incumbent LEC's existing rates as approved by the Commission for each particular GSA.

We propose that the reference or benchmark for calculating the subsidy for each GSA be based on the revenues generated by the LEC offering basic service in that particular GSA. If the proxy cost of serving that GSA is above the benchmark, then that GSA should be considered a high cost GSA, and the carrier or the carriers of last resort serving that particular GSA are eligible to receive funding. (See proposed Rule 6.A.6., App. A.) We also propose to periodically review the subsidy amounts to see if the subsidies for high cost areas should be reduced.[18] In such a review, the Commission should consider whether the cost studies, the proxy costs, or the benchmarks should be revised. Also, the

18 One method is to compare the subsidy per customer with a weighted average of carrier rates. The Commission could reduce the subsidy amount available as basic rates are reduced.

Commission should consider during that review the effects of competition and advances in technology. (See proposed Rule 6.A.7., App. A.) If over time the rates charged fall below the initial reference or benchmark, that would indicate that a reduction in the subsidy amount would be required.

We welcome comments on: (1) whether our proposal achieves a proper balance between the amount of subsidy required, and whether such subsidy will attract other carriers to serve the high cost GSAs; (2) should the initial subsidy amount be determined by using some other benchmark, such as a statewide average of the proxy costs of all the GSAs; and (3) is the periodic review of the subsidy amounts necessary, and if so, how often should such reviews take place and what items would require review or adjustments.

Once the Commission determines the cost of serving the GSAs, and reference or benchmark prices have been established, the amount of subsidy can then be calculated for each high cost GSA. From the total amount of subsidy for each high cost GSA, the Commission can then set the amount of subsidy that is available on a per customer basis. The subsidy would then be collected and distributed based on the number of customers that each designated COLR serves in a high cost GSA.

3. Determining Who the COLR Should Be

As part of our proposal, we will initially require the incumbent LECs to serve and be designated the COLR in all their service areas until such time that another carrier or carriers are designated as the COLR.[19] In the event the incumbent LEC decides to remain as a COLR, it may do so. Other qualified providers may also seek to become a designated COLR in a particular GSA, or to compete in a GSA without being designated as a COLR. However, only

19 This proposed requirement is consistent with Local Competition Rule 5.A.

the designated carrier or carriers of last resort will be entitled to draw from the high cost voucher fund. (See proposed Rule 6.D.3., App. A.)

If a carrier wants to be designated a COLR, it shall file a Notice Of Intent To Be Designated A COLR (NOI) in this proceeding.[20] The NOI signifies that the carrier is willing to undertake the COLR obligation at the established per line subsidy for the cost zone in which the GSA is located.[21] The assigned Administrative Law Judge (ALJ), in conjunction with the assigned Commissioner, shall conduct hearings, if necessary, on the qualifications of the carrier filing the NOI.[22] The Commission will then issue a decision designating which carriers shall be designated the COLR.[23] (See proposed Rule 6.D.4., App. A.)

Anytime after the initial designation of the carrier or carriers willing to undertake the COLR obligation, any carrier who is designated a COLR may opt out of the COLR obligation by filing the appropriate advice letter so long as there is at least one other COLR operating in the same service area. If the carrier opts out as a designated COLR, that carrier is no longer eligible

20 The NOI must comply with Rules 2, 3, 4, 5, and 7, contain information regarding the service areas in which it currently operates in, and a balance sheet and income statement as specified in Rule 17 (h). Interested parties may file protests and responses to the NOI in accordance with Article 12 of the Commission's Rules.

21 The per line subsidy would be determined after the cost studies have been completed.

22 In situations where the carrier is clearly qualified, but a protesting party is seeking to delay the carrier's entry, no hearings need be held.

23 We solicit comment on whether an advice letter and Commission resolution process, or some other method, might be a more appropriate way of handling the designation of carrier or carriers of last resort.

to draw from the high cost voucher fund.[24] (See proposed Rule 6.D., App. A.)

If there is only one COLR left in an area, and that COLR wants to be relieved of the COLR obligation,[25] then the Commission, or its designee, will conduct an auction with qualified bidders to determine who should become the new COLR so as to ensure the continued availability of basic exchange service. The bid will involve the obligation to be the designated COLR for a period of three years. The bidding will start at the established per line subsidy for that GSA. The COLR obligation will be awarded to the bidder whose bid price is the lowest. The winning bid represents the "premium" which we believe will act as an incentive for encouraging a carrier to undertake the COLR obligation.[26] Any other carrier entering this market after the bid has been awarded may compete as a designated COLR entitled to draw 1/2 of the winning bid from the high cost voucher fund.[27] A carrier who

24 In the event a designated COLR no longer wants to undertake the obligation, CACD shall prepare a notice informing the fund administrator that the carrier is no longer eligible for high cost voucher funds in the particular service area. A copy of such notice shall also be placed in the correspondence section of the formal files in this proceeding.

25 If a GSA has only one COLR, and that carrier wants to be relieved of its COLR obligation, the carrier must file an application to do so. (See Local Competition Rule 4.F.(8).)

26 The premium that is awarded should be recovered as part of the high cost voucher fund. This could either be calculated as part of the total subsidy required before the high cost voucher fund is established, or included in the adjustment of the total subsidy during a periodic review of the fund.

27 By permitting another designated COLR to enter, we hope to prevent a situation where the last designated COLR wants to exit the service area so that through the auction mechanism the premium

(Footnote continues on next page)

wants to provide service, but does not want to become a designated COLR will not be able to draw from the fund. (See proposed Rule 6.D., App. A.)

Due to the circumstance that there may be a sole designated COLR, we must have a mechanism in place to decide whether other carriers can be designated a COLR after the three year term expires. Before or on the 180th day before the expiration of the three year COLR obligation, all carriers who are interested in serving as a designated COLR upon expiration of the term shall file an NOI, as described earlier, in this proceeding for that service area. The Commission will then issue a decision to determine whether the same designated COLR will be retained, or if another auction will be held in accordance with proposed Rule 6.E. (See proposed Rule 6.E.3, App. A.)

We invite comments on our proposal as to how the high cost voucher fund and safety net auction mechanism should work. We are particularly interested in how feasible our proposal is, as compared to an all auction mechanism or other alternatives. We are also interested in comments on whether the designated COLR's service territory should be based on GSAs, and whether the carriers who do not want to be designated COLRs should be entitled to select a service territory on a less than GSA basis.

We recognize that the Local Competition proceeding is in the process of issuing interim rules as to entry and

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and subsidy for that service area can be increased. Another alternative that may fix this potential problem is to put a ceiling price on how much of a premium can be bid.

certification rules. However, when a carrier undertakes the COLR obligation, the Commission needs to ensure that the GSA in which the COLR is serving will have a carrier who is capable of fulfilling that obligation. If the COLR were to go out of business and leave a community without telephone service, public health and safety could be endangered, as well as disruption of the local economy. We need to consider whether a COLR should be required to meet criteria beyond the qualifications required of CLCs.

This criteria can be used to determine which carriers should be designated a COLR, and which carriers can participate in the safety net auction. Some of the criteria under consideration are the following: (1) the facilities that the carrier has in place or the arrangements that the carrier plans to enter into so that it can provide local exchange service; (2) the financial ability of the carrier to undertake the COLR obligation; and (3) the commitment of the carrier to promote the goals of universal service in low income and non-English speaking communities. (See proposed Rule 6.D.4., App. A.) We invite comment on whether a COLR should meet specified criteria, or if sufficient safeguards are contained in the Local Competition rules.

4. How the Surcharge Should Be Collected

a. Introduction

The funding source for universal service is extremely important. The Commission stated in its Infrastructure Report that the funding mechanism must be neutral to all carriers and compatible with a competitive market structure.

Currently, the Commission uses all end user surcharges (AEUS) to fund both the ULTS program and the CHCF program. These surcharges appear as line items on customers' bills and represent a percentage of customers' expenditures on telecommunications services. All end users of telecommunications services, with the exception of one-way paging company customers, pay the surcharge amount. The AEUS is effective under the current